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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, APRIL 21 - MAY 5, 2008

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period April 21 - May 5, 2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- Argentina's Country Risk Premium spikes, indicating ever growing uncertainty
-- Standard and Poor's revises Argentina's outlook to negative from stable following Minister of Economy's resignation; spill over effects to the provinces and banks
-- U.S. Judge delays ruling on the freeze of GoA bonds
-- GoA unveils its 2008 Financial Program
-- Special Report: Argentine Economist Miguel Kiguel on Argentina's Fragile Economy, Deteriorating Politics

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Finance

Argentina's Country Risk Premium spikes, indicating ever growing uncertainty
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¶2. (SBU) On April 25, Argentina's sovereign risk premium over equivalent maturity U.S. Treasuries, as measured by JP Morgan's EMBI Plus index (Emerging Market Bond Index), reached 589 basis points, the highest level since the GoA's 2005 debt restructuring. Argentina's Credit Default Swaps (CDS) spread jumped up to a record 599 basis points and local think tank Ecolatina's "Financial Risk Index" (which also measures peso bonds) closed at a new record of 931 basis points.

¶3. (SBU) The factors behind the market's increasing nervousness and the deterioration in all of these indexes (which reflect falling Argentine bond prices) include: 1) JP Morgan's April 2 recommendation to underweight Argentine financial assets; 2) a similar recommendation by Merrill Lynch on April 23, recommending investors reduce from 3.4% to 2.3% Argentina's weight in a benchmark portfolio; 3) S and P's April 25 downward revision on Argentina's sovereign credit rating from stable to negative (details below); 4) the April 18 action of U.S. Judge Griesa to block Argentina from transferring or selling bonds held at the Depository Trust Company (DTC), following a request by holders of defaulted GoA debt (details below); 5) Minister of Economy Martin

Lousteau's surprise resignation on April 24 (it was expected mid-May); and 6) the continuing Ag conflict, which for the moment seems far from resolved (for background see April 4 Econ/Fin Report).

¶4. (SBU) These separate actions together reflect widespread unease with GoA economic policies and increasing concern about the future of the Argentine economy. The GoA's policies (price controls, subsidies, loose monetary and fiscal policy, market interventions, bullying of the private sector, statistics manipulation) have resulted in the an overheating economy, as evidenced by inflation that is likely running at an annual rate of about 25%, and have scared away investment.

¶5. (SBU) With the sell-off of Argentine assets and increased capital outflows, savers and investors (both retail and corporate) have increasingly turned to the dollar as a safe haven. Demand for dollars has sharply increased in 2008, and anecdotal evidence indicates that it spiked on April 25 after Minister Lousteau resigned. (Note: There is a 7-10 day lag on BCRA reports on currency trades). This increased demand also occurred simultaneously with reduced supply of foreign exchange due to lower agricultural commodity exports (a consequence of the strike), which exacerbated the pressure on the peso on April 25. However, the BCRA reacted strongly, selling in the range of US$350 million on April 25 to avoid a sharp peso depreciation.

¶6. (SBU) Although the April 25 market closed with the peso at 3.22 ARP/USD, compared to 3.20 ARP/USD two weeks before (a depreciation of 1.25%), the BCRA sent a strong signal that it

is prepared to use its $50 billion in official reserves to defend the peso. The sell-side rate has stabilized at about 3.20 ARP/USD. Since hitting bottom on April 25, Argentine bond prices have recovered some ground, but are still highly volatile. The EMBI Plus index closed April 30 at 584 bps.

Standard and Poor's revises Argentine outlook to negative from stable following Economy Minister's resignation; spill-over effects to Provinces and Banks
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¶7. (SBU) Standard and Poor's Ratings Services announced April 25 that it had revised its outlook on its sovereign credit ratings for Argentina from stable to negative, while affirming the B plus long- and B short-term ratings on the country. (Note: A negative outlook indicates that downside risks to Argentina's ratings now predominate.) According to S and P, the negative outlook reflects the GoA's failure so far to implement "corrective" economic policies to cool down the overheated economy and decelerate inflation, as well as increased political-economic challenges facing the country in the wake of the resignation of Economy Minister Martin Lousteau. Nevertheless, S and P noted that the outlook could return to stable were the GoA to introduce policies to address the overheating economy and ensure a more sustainable level of economic growth.

¶8. (SBU) Although strong economic activity, rising inflation, and export taxes have helped support a strong fiscal surplus (estimated at 3.3-3.8% of GDP for 2008), S and P is still concerned with wage pressures, distortions in the economy (subsidies and price controls), the agricultural sector conflict, deterioration of social indicators (due to the accelerating inflation), regulation hurting growth prospects, and eroded GoA's popularity. Together, according to S and P, these factors increase the challenges for fiscal policy over the next 18 to 24 months. Furthermore, these factors do not even consider the potential adverse impact of a negative external shock, such as the sudden deterioration of the terms of trade, which would translate into sharply lower fiscal and external surpluses given Argentina's increasing dependence on revenues from exports of major commodities. S and P ended its press release noting that any material fiscal

deterioration would lead it to lower Argentina's rating.

¶9. (SBU) Following the revised sovereign outlook, S and P revised from stable to negative the outlook for the Province of Buenos Aires, Banco Provincia de Buenos Aires, and the Province of Mendoza, while it revised from positive to neutral the outlook for the City of Buenos Aires. Similarly, S and P revised down from neutral to negative the outlook of Banco Hipotecario and Banco Patagonia.

U.S. Judge delays ruling on freeze of GoA bonds
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¶10. (SBU) On April 18, Judge Thomas Griesa -- a federal judge for the United States District Court for the Southern District of New York -- blocked the GoA from transferring or selling a stock of bonds held in the Depositary Trust Co. (DTC) in New York until the nature and ownership of these bonds could be clarified. The ruling was issued following a request by a holder of defaulted Argentine bonds who did not participate in the 2005 debt exchange, and who is litigating against the GoA. (Other so-called bond holdouts reportedly later joined the suit.) The litigant intends to attach the blocked bonds to satisfy his claim against the GoA.

¶11. (SBU) Background: The blocked bonds are global bonds swapped by the GoA in November 2001 (before the default) for guaranteed loans (Prestamos Garantizados) and kept in an account as a guarantee to the owners of the guaranteed loans. This exchange had a critical feature that allowed the guaranteed loans to revert to the original bonds (the globals) if the GoA were to default on its obligations (and not honor the guarantee). Most of the guaranteed loans were originally issued in dollars. However, the GoA converted the bonds to pesos in 2002 and linked them to CER (a CPI-linked index). Since then, they have always been performing debt. Meanwhile, the global bonds, which belong to series of bonds that entered in defaulted in 2001 and were later restructured in 2005, have remained as collateral of the Guaranteed Loans and not destroyed.

¶12. (SBU) Judge Griesa announced on April 30 that he would delay issuing a ruling on this case pending further review of the arguments and evidence submitted to the court. Key in this case is to properly assess who has the ownership of the frozen global bonds. The GoA's lawyers claim that the global

bonds do not belong to the GoA but to the owners of the guaranteed loans, and as a result they cannot be attached by the holdouts. The plaintiffs claim that GoA decrees in 2002 and 2003 pesifying the guaranteed loans had "stripped" holders of the guaranteed loans of their ownership of the globals. Therefore, according to this line of argument, the globals belong to the GoA and are attachable. (Note: the global bonds have still a residual value, since untendered defaulted bonds currently trade at about 30% of face value.)

¶13. (SBU) Also, in the hearing Judge Griesa granted an order for discovery (in favor of the litigating investors/plaintiffs), requiring the GoA and DTC to surrender information to the plaintiffs about the bonds that are frozen. However, Griesa denied a motion to broaden discovery for the purpose of attachment to European jurisdictions (in favor of GoA's defense). There is not even agreement on the face value of the bonds tendered in the November 2001 debt exchange and held in DTC. In their legal briefs, the plaintiffs claimed that the face value of these bonds is about $18 billion, whereas the GoA's lawyers argued that the face value is only $2 billion. According to JPMorgan, which attended and reported on the hearing, the GoA's defense did a better job of articulating their arguments. However, the judge left the door open for the litigating investors, by providing additional time to bring evidence to support their claims and establish ownership of the global bonds.

¶14. (SBU) For the time being, the lack of a ruling represents

an obstacle to the GoA's plan of carrying out a mini-debt exchange of local debt (including guaranteed loans), in order to smooth the GoA's maturity profile for 2009-2011. Not only would the debt swap reduce the GoA's financing needs over this period, senior Economy Ministry officials expect it would ease market anxiety over Argentina's ability to roll over its maturing debt. These senior Economy Ministry contacts speculate that the bond holdouts do not expect to win this court case. Their real purpose, they say, is to delay the debt exchange and highlight the constraints and costs to the GoA of not resolving the holdout issue. There is a precedent: the settlement of the 2005 GoA debt restructuring agreement was delayed almost three months, from the original settlement date in March 2005 to June 2005 due to similar holdout bondholder legal actions.

GoA unveils its 2008 Financial Program

¶15. (SBU) The GoA released its long-promised 2008 Strategic and Financial Program on April 18, surprising market analysts who had speculated the GoA would never issue the plan due to increasing domestic and international uncertainty. The GoA Economy Ministry had committed itself early in the year to give details on the types of transactions and markets it would tap during the year to fulfill 2008 financial needs, with the objective of improving transparency and predictability for investors. However, the Ministry had delayed the release until now to avoid being held to its publicly presented program during a period of strong market volatility.

¶16. (SBU) According to the program, as of end-April the GoA's financial needs stand at $6.1 billion, which the Economy Ministry expects to raise by: a) domestic auctions ($3.6 billion); b) direct private placements ($1.5 billion); and c) intra-public sector placements ($1.0 billion). Highlights of GoA's 2008 financial program include:

-- Promoting an active dialogue with market participants, so as to issue bonds considering investor's needs and GoA's objectives;
-- Issuing reference bonds (in pesos, foreign currencies and at fixed and variable rates), for a minimum amount of $1.0 billion -- to ensure sufficient volume to guarantee liquidity;
-- Promoting strong participation of local institutional investors with a strong liquidity position, with estimated potential demand of:

-----$1.9 billion from Pension Funds, Mutual Funds and Insurance Companies;
-----$1.0 billion from Intra-Public sector agencies; and
-----$700 million from Banks.

-- Coordinating closely with the BCRA;
-- Increased lending from International Credit Institutions;
-- Performing Liability Management transactions (debt swaps) to smooth the GoA's debt maturity profile.

¶17. (SBU) Preliminary estimates of 2009 and 2010 financial needs of $11.9 billion and $10.5 billion, respectively. These figures are significantly higher than 2008 and may challenge the GoA's ability to meet its financing needs, absent a debt swap of outstanding Guaranteed Loans, which face large amortizations in the next three years. (See background on proposed debt swap in April 4 Econ/Fin Report).

Special Report

Argentine Economist Miguel Kiguel on Argentina's Fragile Economy, Deteriorating Politics
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¶18. (SBU) Noted Argentine Economist and Business Consultant Miguel Kiguel offered an April 29 conference call briefing on the state of the Argentine economy to his clients. Here are highlights:

-- Farmers' strike changed political climate and eroded the GoA's popularity. This was the Kirchners' first political loss, and they were deeply surprised by the popular support for the farmers' protests. The middle class joined in due to their frustration over lack of GoA action to curb inflation. In the past, the Kirchners have chosen "enemies to attack" that were not in a position to respond: IMF, bondholders, large energy companies, USG. This time the conflict was with 300,000 farmers spread throughout the country -- impossible to control.

-- Economy Minister Lousteau's resignation. Although Lousteau was blamed for the "retenciones moviles" (sliding export taxes), it is unclear who was really behind them. It is not a new idea, and other GoA officials are known to have proposed them before, including Internal Trade Secretary Guillermo Moreno. The main goal was to appropriate part of Ag commodity exporters' windfall gains, but after unexpected backlash Lousteau was marginalized and scapegoated. Before resigning, Lousteau presented an anti-inflation program (and leaked it to media), but this was his way of trying to leave office with honor after a mediocre tenure as Economy Minister.

-- Expectations for new Economy Minister. Minister Carlos Fernandez is a technocrat who understands the fiscal side but has no experience in macroeconomic policy, at a time where the country needs a Minister familiar with exchange rate and monetary policies. Fernandez will have limited autonomy, and it appears Guillermo Moreno emerges even stronger. The perception is that there will be even less reliance on market forces and interventionist trends -- price controls and pressure on companies -- will continue and increase. KEY POINT: At least Lousteau had technical skills and ideas for controlling inflation and reforming INDEC. Now, there is no sponsor in the GoA for INDEC reform or rational economic policies (except, possibly, BCRA President Martin Redrado); the scope for policy mistakes is wide open and there is no counter-balance to Nestor Kirchner.

-- Recent depreciation of the peso and how much more to expect? As a result of increasing uncertainty, there are growing rumors of further peso depreciation and dual exchange rate systems. In spite of inflation, the peso is still undervalued in real terms against the dollar and (even more so) against a basket of currencies. However, less competitive industries that are benefiting from the depreciated peso are demanding further depreciation to compensate for the real peso appreciation. They are getting some support from farmers, who see a more depreciated peso as partially making up for the increased export taxes (although revenues to most farmers are in pesos). (Post comment: BCRA economists are openly opposed to further depreciation.)

-- Increases in the CDS and in long-term interest rates, though short-term rates remain low. Argentina's Credit Default Swap (CDS) spread has widened to 600 bps, and other country risk measures (e.g., the EMBI plus) have also increased. This reflects concerns regarding the GoA policy mix more than fundamentals, since the GoA's capacity to pay debts is solid in the medium term. However, the perception from abroad is that anything is possible with Nestor Kirchner pulling the economic policy strings, so foreign investors are rapidly reducing exposure. Long-term peso interest rates are increasing, but the short-term (BADLAR) rates are only slightly higher than their pre-strike level in March. Low

short-term rates have been supported by two factors: Argentine banks and insurance companies are currently very liquid, and local institutional investors are not concerned

about short-term changes to the exchange rate. Both of these factors are changing (particularly as the soybean crop is sold and liquidity declines). Expect BADLAR rates to approach rate of inflation.

-- Outlook for inflation. This is the main problem facing the GoA, but no one knows the exact number. Annual inflation was approximately 20% in 2007 and is running at about 25% so far in 2008. However, there is no reason to expect spiraling (or hyper-) inflation. Wage increases so far in 2008 have been relatively conservative, with the major unions accepting a 19.5% increase (or 23-24% including benefits), which is similar to 2007. Also, the big jump in inflation took place in 2007 due to high wage and pension increases, also spurred by the GoA's 55% annual increase in expenditures. Fiscal is more conservative now, growing at about a 35% annual rate, and the primary fiscal surplus is stronger (mostly due to October 2007 increase in export taxes). While not contractionary, the GoA's fiscal policy is more prudent and less inflationary. The BCRA's policies are accommodating higher inflation, with its management of the undervalued currency, the large, negative real interest rates, and no signs of tightening of the money supply. (The BCRA's 2007 target for M2 growth was 18-19%, whereas it is 23.5% for 2008 -- and with private M2 target growth of 26%.)

-- Clearly, the rate of economic growth is above potential, there is a tight labor market, and there is excess aggregate demand, all of which lead to higher inflation. However, of most concern is the total absence of any GoA anti-inflationary program. There are three essential components to an anti-inflation plan:

----- Tighter fiscal and monetary policy to bring down aggregate demand.
----- Institute a Nominal Anchor (could be the money supply or inflation targeting -- slow economy or adjust the exchange rate. Right now there is only a relatively stable nominal exchange rate. Obviously, if the GoA gives in to industry demands for further depreciation, inflation will jump.)
----- A change in key relative prices, particularly the real exchange rate and real interest rates (probably need stronger peso and definitely need higher nominal interest rates).

-- Financing requirements. The GoA only needs to raise about $4 billion in 2008, which it will do easily by tapping local pension funds (which have roughly $6 billion they must invest domestically this year) and the Social Security Agency (ANSES). Financing needs jump to $9-10 billion in 2009, which will be more difficult for the GoA but still manageable. The GoA should be able to raise over $4 billion easily from domestic capital markets and several billion in short-term borrowing from the BCRA (which is within BCRA Charter limits), and will be able to fill the rest with private placements to domestic agencies (ANSES). (Post Comment: Venezuela's continuing willingness to purchase Argentine debt will be an increasingly important factor.) It is wishful thinking that the GoA will improve its relationships with capital markets. With the departure of Lousteau and Finance Secretary Hugo Secondini, the proposed debt swap of Guaranteed Loans and Bodens is on hold. It would have been difficult/impossible to do anyway due to the ongoing Holdouts court case in New York. The new Minister will likely put emphasis on new financing rather than on smoothing maturities through a debt exchange. New Finance Secretary Hernan Lorenzino was involved in the Buenos Aires Province debt exchange in December 2005, is competent, and understands financial markets, although he does not have Secondini's experience.

-- Medium-term outlook. Not too concerned about the fundamentals, and the twin surpluses (fiscal and trade) reduce macroeconomic risks. Growth should continue for the next few years at least in the 4-5% range, as long as the favorable external environment continues. Financing requirements and debt sustainability are not concerns. Inflation is the major problem in the medium term, and the main downside risk is "stagflation." At this point,

arresting inflation will require a major shift in macroeconomic policy, absent which inflation will likely rise by 2009 to the 30-35% range. This high inflation and the resulting strengthening of the peso in real terms will both affect production, as will higher interest rates. The result will not be the typical Argentine crisis, because the GoA

will not face problems servicing debt. Rather, real GDP growth would drop to 2.5-3% per year, low compared to previous years and also low compared to Argentina's peers in the region.

-- The biggest questions are political. President Kirchner's beginning has been highly disappointing for investors, who had hoped for "gradual fine-tuning" of policies, stronger institutions, and a more international outlook. Instead, (in Kiguel's view) the GoA's relations with important allies such as the U.S. and Spain have deteriorated, Argentina is becoming closer to Venezuela, and there are few signs of advancement on key financial issues such as holdout bondholders or Paris Club. In summary, the economic situation is deteriorating gradually, the political situation has deteriorated considerably, the leadership has minimal economic background, there is no counterbalance to bad economic policy decisions, and downside risks have increased dramatically. The best hopes right now are that the fall in President Kirchner's approval rating may force the administration to act, and also that the Governors of the major Provinces are becoming more vocal in support of more sensible policies.
WAYNE